Memorandum

To: Jeff Duncan, Legislative Director, Rep. Markey
From: Office of Public Utility Regulation
Subject: PUHCA Amendment Sponsored by Sen. Kerrey
Date: September 19, 2000

Per your request for technical assistance, the following discussion highlights some of the principal issues raised by the proposed amendment. It has been prepared by the SEC staff, but it does not, however, represent a formal expression of SEC views.

Text of Proposed Amendment

The proposed legislation would amend the Act to provide that:

> A company shall not be considered a holding company under the Public Utility Holding Company of 1935 and such company and each subsidiary company thereof shall be exempt from all provisions of such Act if such company has an issuer rating of "A" or better or has at least one class of non-convertible debt or preferred securities which has been assigned an "A" rating or better, in either case by at least one nationally recognized statistical rating organization, and each subsidiary company of such company which is a public utility company and which has a class of non-convertible debt or preferred securities registered under the Securities Exchange Act of 1934, as amended, has been assigned an investment grade rating by at least one nationally recognized statistical rating organization.

We understand the amendment to provide that a public-utility holding company that qualifies for the exemption (a "Qualifying Holding Company") will not be considered to be a public-utility holding company under the Act, and both it and its subsidiaries will be exempt from all provisions of the Act. To qualify for the exemption, two conditions must be satisfied: (1) the public-utility holding company must have an issuer rating of at least "A" or must have outstanding at least one class of non-convertible debt or preferred securities that has been assigned a rating of at least "A," in either case by at least one nationally recognized statistical rating organization ("NSRO"); and (2) each public-utility subsidiary company that has outstanding a class of non-convertible debt or preferred securities registered under the 1934 Act must have been assigned an investment grade rating by at least one nationally recognized NSRO. It is our understanding that public-utility subsidiary companies that do not have the described types of debt outstanding would be disregarded for purposes of determining that a holding company is a Qualifying Holding Company.

Comments

Background

Congress determined in 1935 that direct federal regulation was necessary to control the operations of multistate public-utility holding companies. The extensive factual studies that preceded enactment documented a pattern of widespread abuses that were detrimental to both investors and consumers. These studies formed the factual basis for the statute and are expressly cited in section 1(b), which sets forth the abuses that the Act was intended to remedy and prevent.

The Act requires holding companies with multistate operations to register with the Commission and to comply with a comprehensive federal framework of regulation. Under the Act, a registered holding company is generally limited to a single, integrated public-utility system and to those nonutility businesses that are "reasonably incidental, or economically necessary or appropriate" to the system's utility business. The Act contemplates transparent corporate and capital structures. It regulates the ability of registered system companies to issue or sell securities or alter the rights of security holders; acquire any securities or utility assets or any interest in a nonutility business; or sell utility assets or securities. The Act also regulates intrasystem loans and extensions of credit, as well as affiliate service, sales and construction contracts. In addition, registered holding companies are subject to extensive reporting and accounting requirements.

The goals of the Act include, but are not limited to, the financial health of companies in holding company systems. Under the Act, among other things, the Commission has required registered holding companies to maintain a simple and balanced capital and corporate structure and to limit nonutility diversification (other than investments in exempt entities, such as foreign utility companies ("FUCOs"), exempt wholesale generators ("EWGs) and exempt telecommunications companies) to activities that are related to the core utility business. The Commission has adopted rules to ensure that statutory provisions are satisfied, such as rules, for example, under section 13(b) of the Act to ensure that transactions among associate companies in registered systems involving services, sales and construction are "performed economically and efficiently for the benefit of such associate companies at cost, fairly and equitably allocated among such companies."

Section 3(a) of the Act makes an exemption from registration available to five types of holding companies. Congress made these exemptions available because the holding companies described are either susceptible of effective state regulation or are otherwise not the type of holding company at which the Act is directed.

The most frequently used exemptions are those provided in section 3(a)(1) for an intrastate holding company and in section 3(a)(2) for a holding company that is

"predominantly a public-utility company."[1] In addition, section 3(a)(3) provides an exemption for a company that is "only incidentally a holding company," being primarily engaged in another business; section 3(a)(4), for a company that is only "temporarily a holding company;" and section 3(a)(5), for a holding company with essentially foreign utility interests and no material domestic utility operations.

Section 3(a) requires the Commission to exempt from "any provision or provision of the Act" (except section 9(a)(2), as explained below) any holding company that satisfies the objective requirements of section 3(a), "unless and except insofar as [the Commission] finds the exemption detrimental to the public interest or the interest of investors or consumers." The "unless and except" clause "was designed to prevent the exemption of any holding company which, although it might satisfy the formal conditions under section 3(a), is essentially the type of company at which the purposes of the Act are directed. In addition, under section 3(c), the Commission can modify or revoke an exemption if it finds that the circumstances that gave rise to the exemption no longer exist.

In the early 1980s, the Commission determined that the purposes of the Act had been achieved and recommended to Congress that the Act be repealed. Due in part to concerns about consumer protection, repeal legislation was not passed. The *1995 Report* of the Commission staff recommended repeal of the Act, conditioned upon measures to ensure consumer protection. Specifically, the *1995 Report* contemplated enactment of legislation that would ensure access to books and records needed for the effective discharge of a state's regulatory responsibilities and provide for federal audit authority and oversight of affiliate transactions. The *1995 Report* envisaged that the task of enforcing such provisions would be entrusted to the Federal Energy Regulatory Commission ("FERC") as the federal agency with direct responsibility for the protection of energy consumers. The *1995 Report* further recommended that any repeal legislation should include a minimum one-year transition period to allow states, utilities and other affected parties to prepare for the new regulatory regime. The Commission has testified before Congress in support of these recommendations, most recently on May 6, 1999.[2]

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[1] The exemptions under sections 3(a)(1) and 3(a)(2) are based on the assumption that a state can effectively regulate a holding company that operates and is organized in one state, or a holding company that is essentially an intrastate operating company with minor subsidiary operations. *The Regulation of Public-Utility Holding Companies*, Division of Investment Management, United States Securities and Exchange Commission, June 1995 ("*1995 Report*") at 111 (citations omitted).

[2] *See Concerning the Public Utility Holding Company Act of 1935: Hearings on H.R. 1587 and H.R. 667 Before the Subcomm. on Energy and Power*, U.S. House of Representatives, 106th Cong., 1st Sess. (1999) (testimony of Isaac C. Hunt, Jr., Commission, SEC).

Proposed Exemption

We believe that the proposed exemption would exempt 10 of the existing 20 registered holding companies and as many as one half of the existing exempt holding companies.[3] No additional authority would be granted to the FERC to ensure consumer protection. Instead, the actions of an NRSO, a non-governmental authority, would effectively exempt holding companies from all provisions of the Act based on an assessment of the investment qualify of system debt.

Registered Qualifying Holding Companies would no longer be subject to the substantive requirements of the Act described above.[4] Thus, for example, the Act would no longer regulate the ability of a formerly registered company to issue, sell and acquire securities; acquire and sell utility assets; enter into any type of diversified business, whether domestic or foreign; or engage in financings for the purpose of acquiring FUCOs and EWGs. The holding company would no longer be required to maintain a simple capital and corporate structure under section 11(b)(2) of the Act.[5] Restrictions on intrasystem loans and extensions of credit, as well as affiliate service, sales and construction contracts would be removed. Finally, the holding company would no longer be subject to the current extensive reporting and accounting requirements.

In addition, no Qualifying Holding Company, whether registered or exempt, would remain subject to section 9(a)(2) of the Act, which would otherwise require approval under the standards of section 10 for the acquisition of any security of any public-utility company by "any person" that is, or will by virtue of an acquisition become, an affiliate of two or more public-utility companies.[6] A Qualifying Holding Company would thus no longer be subject to the statutory requirements applicable to utility acquisitions, and could acquire any utility, wherever located, so long as the acquisition was compatible with qualification for exemption.

The proposed exemption, unlike the existing section 3(a) exemptions, is not based on effective state regulation or other circumstance suggesting that the historical abuses

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[3] These numbers assume that commercial paper constitutes non-convertible debt within the meaning of the draft amendment.

[4] Although the draft amendment does not so provide, the accompanying materials state that "[i]f the [holding] company ever failed to satisfy the qualifications, it would become subject to all of the existing PUHCA requirements and restrictions." The potential administrative difficulties raised by this feature of the proposed amendment are discussed below.

[5] These requirements of the Act are not duplicated by other legislation.

[6] For purposes of section 9(a)(2), an "affiliate" is any person that directly or indirectly owns 5% or more of the outstanding voting securities of a public-utility company. Section 2(a)(11)(A) of the Act.

identified in section 1 of the Act are unlikely to recur. Instead, the proposed exemption appears to rest on the assumption that the activities of a holding company that satisfies the proposed financial standards would not implicate the abuses that led to enactment of the statute. Actions of the NSROs would serve as a proxy for the protection of the interests of investors and consumers. For the reasons discussed below, it is not clear that this assumption is sound. In addition, the proposed exemption would not be subject to an "unless and except" clause. If historical abuses should recur or detriment to the protected interests otherwise arise, the Commission would lack jurisdiction to address the situation.[7]

The accompanying materials state that the proposed exemption establishes a "transitional market-based regulatory alternative" to the Act that "will encourage new, well capitalized entrants into the utility industry, providing much needed investment and additional competition." The materials further state that the proposed exemption "[r]etains the consumer and investor protections of PUHCA, while creating a new exempt category fully consistent with the purposes of the Act."

It appears, however, that proposed exemption would permit transactions and practices that could adversely affect investors and consumers. Several examples follow. By permitting unlimited nonutility diversification in the U.S. and abroad, the exemption could be detrimental to U.S. investors and consumers.[8] Foreign registered Qualified Holding Companies would no longer be required to hold U.S. investments in a separate chain from their foreign interests; like other previously registered holding companies, they would no longer be subject to the current reporting and accounting requirements. As a result, the immediate transparency of their corporate and capital structures, which is not duplicated by any other regulatory regime, would be lost. Affiliate transactions such as intrasystem loans, the declaration and payment of dividends, the disposal of assets and securities would no longer be subject to federal oversight. Whereas the Act was intended to supplement state regulation, it appears that the proposed exemption would impair state regulators' efforts to protect ratepayers. Absent federal reporting requirements, information concerning the activities of Qualifying Holding Companies would generally be unavailable to interested state regulators.[9]

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[7] The Commission has historically considered the appropriateness of nonutility diversification by exempt holding companies, and their capital structures – matters not directly regulated by section 11 of the Act -- under the "unless and except" clause of section 3(a).

[8] Apart from investments in EWGs and FUCOs, the Commission has authorized limited nonutility diversification outside the United States to date.

[9] Most states do not have jurisdiction over holding companies within their borders. In addition, the 1995 Report noted that many states had reported to the Commission that they cannot readily obtain the books and records of an out-of-state holding company.

The accompanying materials claim other benefits for the exemption, stating, for example, that it "[p]rovides relief from an unintended side effect" of the Act; "[e]nsures that any company qualifying for this exemption meets and exceeds the financial soundness of registered holding companies; and "[p]rovides a regulatory incentive for existing registered holding companies to maintain highly stable financial structures." These statements are discussed in turn below.

The "unintended side effect" of the Act, not specifically identified, is said to make it easier in many instances for a foreign company to purchase a U.S. utility or holding company than a domestic company. The materials appear to refer obliquely to an analysis contained in the Commission's recent order in *National Grid plc*, Holding Co. Act Release No. 27154 (Mar. 15, 2000) ("*National Grid*") authorizing a U.K. company to acquire New England Electric System ("NEES"), a domestic registered holding company. Following the acquisition, National Grid would register under section 5 of the Act.

In *National Grid*, the Commission determined, among other things, that the existing foreign utility properties of National Grid could qualify for FUCO status under section 33(c)(1) of the Act. As a result, National Grid could acquire NEES without regard to the integration of the foreign and domestic utility operations, which would otherwise have been required under sections 10 (c), 11(b)(1) and 2(a)(29)(A) of the Act.[10]

It should be noted that the "FUCOization" of National Grid's existing foreign utility properties did no more than place National Grid in the same position as a domestic acquiror that has no existing utility operations when it acquires its first holding company. For any subsequent utility acquisition, both the foreign and the domestic company would have to obtain prior Commission approval under section 10 of the Act.[11] We do not believe that the "FUCOization" of a foreign acquiror's existing utility operations offers an unfair advantage under the Act to foreign, as opposed to domestic, acquirors.[12]

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[10] The Commission had published a concept release in December 1999, soliciting comments on the application of section 33 of the Act, concerning FUCOs, and comments generally on the registration and regulation of foreign holding companies. The *National Grid* order notes the comments that were received concerning effective regulation of foreign holding companies and the need for even-handed regulation of domestic and foreign holding companies.

[11] If the acquiror were required to register following the acquisition, its nonutility businesses, like those of National Grid, would have to comply with the applicable statutory standards. The ability of a foreign acquiror to "FUCOize" its existing businesses could give it an advantage over a domestic company in this regard. We note, however, that the Commission has not had occasion to address the potential limits of "FUCOization."

[12] In *National Grid*, the Commission concluded that permitting the acquisition would not undermine the policies of the Act or be detrimental to the interests of investors or consumers. The Commission noted, among other things, that National Grid would register; that it would be regulated in the same manner and to the same degree as U.S.-

The other assertions that the proposed exemption "[e]nsures that any company qualifying for this exemption meets and exceeds the financial soundness of registered holding companies" and that it "[p]rovides a regulatory incentive for existing registered holding companies to maintain highly stable financial structures" could prove true. But, as suggested above, it appears that the interests of investors and consumers could suffer detriment nonetheless. For example, the exemption would permit the creation of a complex, possibly opaque, capital structure. The exemption would remove restrictions that Congress, in the Energy Policy Act of 1992, deemed necessary for the protection of U.S. consumers to place upon financings by registered holding companies for the purpose of investing in EWGs and FUCOs. Exempt Qualifying Holding Companies would also be freed from their existing obligations concerning these investments.

Holding companies would face regulatory uncertainty, depending upon actions of the NSROs, under the proposed amendment. In addition, the exemption appears to offer significant administrative difficulties.

As drafted, the exemption would apparently be self-executing. No filing with the Commission would be required. The accompanying materials state that the exemption would not be permanent, but could be lost if a Qualifying Holding Company did not continue to satisfy the requirements of the exemption. The amendment would not require the Commission to monitor continuing entitlement to the exemption and it is not clear, in the absence of reporting requirements, how the Commission would obtain the information that would enable it to do so on a timely basis.

A more serious administrative difficulty is raised by the effective division of holding companies into two groups, the one group exempt -- provisionally -- from all provisions of the Act, the other required either to register (or remain registered) or to qualify for exemption. As explained previously, Qualifying Holding Companies could engage in unregulated activities at will, *e.g.*, make utility and nonutility acquisitions and engage in financings, without regard to provisions of the Act and Commission rules that would otherwise apply. If the exemption were subsequently lost, however, the holding company, especially a registered one, would probably no longer comply with one or more

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domiciled registered holding companies; that it had taken affirmative steps to assure that the Commission could exercise its jurisdiction (*e.g.*, appointment of agents in the U.S. to accept service of process; access to books, records and financial statements); that the interested state regulators did not object to the acquisition; that National Grid's foreign investment was not of such magnitude to raise concerns under the Act; that the acquisition would not divert U.S. personnel and capital to National Grid's operations; and that National Grid had developed other structural safeguards designed to limit the risk that financial problems arising in its FUCO investment would adversely affect U.S. ratepayers and NEES security holders.

The Commission has yet to consider the registration of Scottish Power plc, a U.K. company that has acquired PacifiCorp, a U.S. exempt holding company.

requirements of the Act. For example, the company's capital structure could contravene the requirements of section 11(b)(2) of the Act. Its utility operations and diversified investments could fail to satisfy section 11(b)(1). Its FUCO and EWG investments could extend far beyond those authorized for other holding companies subject to the Act. Issues would then arise as to whether remedial action by the Commission would be necessary or appropriate. The possibility that the holding company could again qualify in the future for exemption from all provisions of the Act would make the problem of noncompliance with the Act all the more difficult to resolve.

Finally, it appears that the proposed exemption, which, as noted above, is characterized in the accompanying materials as a "transitional market-based regulatory alternative" to the Act, would effectively repeal the statute with respect to Qualifying Holding Companies. Although the accompanying materials state that the exemption "[d]oes not provide special treatment for any one market participant or class of participants" because any company could qualify, the exemption would have the effect of creating two classes of holding companies: unregulated Qualifying Holding Companies and holding companies that are subject to the Act. This regulatory approach would appear to create an unlevel playing field.

PUHCA Amendment Sponsored by Sen. Kerrey

You have requested SEC staff technical assistance in analyzing a proposed amendment that would exempt public-utility holding companies from the Act if certain of their securities and those of their utility subsidiaries had investment grade ratings. The attached discussion highlights some of the principal issues raised by the amendment. It has been prepared by the SEC staff, but does not represent a formal expression of SEC views. A summary is provided below.

PUHCA Background

The Act requires holding companies with multistate utility operations – currently 20 companies -- to register with the SEC and comply with a comprehensive regulatory framework. To prevent the recurrence of widespread abuses that led to enactment, the Act generally limits utility operations of registered companies to a single integrated system and their nonutility businesses to those that are functionally related to the utility business. Utility and nonutility acquisitions and intrasystem loans and other affiliate transactions are regulated. The Act makes exemptions from registration available where effective state regulation is likely or the company is not the type of holding company at which the Act is directed. Prior SEC approval for utility acquisitions by exempt holding companies is required.

SEC Position on PUHCA

In 1995, the SEC staff recommended repeal, conditioned upon enactment of legislation that would ensure access to books and records for the effective discharge of the states' regulatory responsibilities and federal audit authority and oversight of affiliate transactions. The SEC contemplated that the Federal Energy Regulatory Commission ("FERC"), as the federal agency with direct responsibility to protect energy consumers, would have responsibility to enforce such provisions. The Commission has testified before Congress in support of these recommendations, most recently on May 6, 1999.

Proposed Exemption

It appears that 10 of the 20 registered holding companies would qualify for the proposed exemption and up to one half of exempt holding companies. The FERC would not play any new role in the protection of consumers.

The proposed exemption does not bear any necessary relation to the purpose of the Act to promote effective state regulation. It also appears that the exemption could lead to complex corporate and capital structures and other transactions and practices detrimental to the interests of investors and consumers. It would also raise serious administrative difficulties. It would effectively repeal the Act for qualifying holding companies, but only provisionally. If a holding company ceased to qualify for exemption, its noncompliance with the Act would raise difficult issues. In addition, by creating two classes of holding companies, the proposed exemption would create an unlevel playing field.